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No. 80

In the Supreme Court of the United States

OCTOBER TERM, 1932

MURPHY OIL COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 231–247)[1] is reported in 15 B. T. A. 1195. The opinion of the Circuit Court of Appeals for the Ninth Circuit (R. 268–295) is reported in 55 F. (2d) 17.

[1] Both the taxpayer and the Commissioner sought review of the Board's decision. Separate petitions were filed, but the cases were heard together by the Circuit Court of Appeals and disposed of in one opinion. While the records in both cases have been printed in this Court, all references in this brief are to the second record, which was No. 6459 in the court below.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 11, 1932. (R. 296.) A petition for rehearing was denied February 23, 1932. (R. 297.) The petition for certiorari was filed May 16, 1932, and was granted May 31, 1932. (R. 304.) The jurisdiction of this Court rests upon Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Article 215 (a) of Treasury Regulations 45 (as amended by T. D. 3938, *infra,* p. 31), promulgated pursuant to Section 234 (a) (9) of the Revenue Act of 1918 (*infra,* p. 27), provides that where a lessor of oil property receives a bonus in addition to royalties a depletion deduction shall be allowed with respect to the bonus in a specified proportion. Is this Regulation valid?

2. Before T. D. 3938, *supra,* Article 215 (a) (*infra,* p. 29) provided that a bonus paid to a lessor of oil property in addition to royalties should be considered as a return of capital and deducted from the capital sum recoverable through depletion. If the amended Regulation is invalid, was the original Regulation valid?

3. Petitioner in the present case leased its oil properties in return for bonus payments and royalties. The Commissioner, applying the original

Regulation, deducted the sum of the bonus payments from the amount recoverable by petitioner as depletion. This resulted in a reduction of the depletable base for 1919 and 1920, and the Commissioner accordingly determined deficiencies for those years, from which petitioner appealed to the Board of Tax Appeals. The Regulation was amended before the hearing in the Board, but petitioner did not produce any evidence to bring itself within the amended Regulation. The decision of the Board that the amended and original Regulations were invalid and that the bonus payments were entirely income was reversed by the Circuit Court of Appeals, which held the amended Regulation valid. Was it error for the Circuit Court of Appeals under the circumstances of this case to refuse to remand the case to the Board to permit petitioner to bring itself within the amended Regulation by further proof?

STATUTES AND OTHER AUTHORITIES INVOLVED

These are set forth in Appendix A, *infra,* pp. 27–33.

STATEMENT

This was a petition to the Circuit Court of Appeals for the Ninth Circuit to review an order of the Board of Tax Appeals which held that the respondent had erred in determining a deficiency of $398,400.53 in petitioner's income and excess-

profits taxes for the years 1919 and 1920. The parties filed a brief stipulation of facts in the Board (R. 53–56), to which was appended a number of exhibits, of which only Exhibit F (R. 179–224) is material here. The Board's findings of fact (R. 234–240) are meagre, and a complete statement of the case requires reference to other portions of the record.

Petitioner, a California corporation, acquired the Whittier and Coyote oil properties before March 1, 1913 (R. 234), and leased them to the Standard Oil Co. of California on December 1, 1913, for 40 years (R. 237, 179–224). The lease called for a royalty of one-fourth of the oil produced, and in addition cash payments to petitioner of $4,000,000, payable in installments on specified dates between 1914 and 1918, which were not dependent on production. (R. 238, 181.) Petitioner also received a down payment of $1,500,000 in 1913. (R. 238.) The Commissioner determined that portions of these payments were consideration for the transfer of fixtures, machinery, and equipment, etc., and that the remainder of $5,173,595.18 was a bonus payment for the lease. Of this remainder he allocated $4,517,402.70 to the Coyote property and $656,192.48 to Whittier. (R. 239.)

It does not appear whether petitioner reported the bonus payments as income in the years when

received nor whether petitioner paid any income taxes with respect to such sums in those years.[2] Petitioner's books showed net income of $910,609.09 for 1919 (R. 14) and $2,881,680.14 for 1920 (R. 16).[3] Nevertheless petitioner's income and excess-profits tax returns for those years apparently showed that no tax was owing. (R. 16, 18, 250.) For the year 1919 this result was due in part to a claimed deduction of over $1,370,000 for legal expenses in and the cost of settlement of a suit with respect to the oil lands. (R. 14.) It does not appear what method of calculation was used to produce the same result for the year 1920.

On April 24, 1926, petitioner took an appeal from the Commissioner's determination to the Board of Tax Appeals. (R. 6.) In its second amended petition, filed September 21, 1928 (R. 38), petitioner urged that the Commissioner had erred in treating the bonuses as a return of capital.[4] On

[2] While under these circumstances it may be assumed that petitioner paid no income taxes on the bonuses when received, the burden having rested on it to show the contrary, we have been informed by the Treasury Department that no such taxes were in fact paid except for 1913, and a part of that year's payment was refunded.

[3] The Commissioner's calculation of petitioner's net income for 1919 and 1920, subject to depletion deductions, was $2,636,882.78 and $2,988,550.51, respectively. (R. 14, 16, 269.)

[4] Petitioner also contended that the Commissioner should have permitted it to deduct the sum of over $1,370,000, made up of legal expenses and the cost of settlement of a suit. This contention was rejected by both the Board of Tax Appeals (R. 240–243) and the Circuit Court of Appeals

November 13, 1926, Article 215 (a) of Regulations 45 had been amended by T. D. 3938, V-2, C. B. 117, to provide that where a lessor receives a bonus in addition to royalties a depletion deduction shall be allowed in respect of the bonus in an amount equal to that proportion of the March 1, 1913, value which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received (*infra,* p. 31). After the hearing before the Board the Commissioner filed a brief (quoted in part in the opinion of the Board at R. 244) admitting that he had erred in failing to apply the amended Regulation, but urging that his computation should be sustained because of petitioner's failure to bring itself within the amended Regulation by proof of the amount of royalties expected to be received during the life of the lease.

The Board (four members dissenting and one taking no part) held that the bonus was entirely income and that no depletion allowance was permissible with respect to it. It expressly held the

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(R. 291–295), and is not now being urged by petitioner. In the Board it was also argued that the Commissioner had erred in deducting the full amount of depletion for the years 1913 to 1915 instead of such sums only as petitioner was entitled to deduct as depletion for those years under the Income Tax section of the Tariff Act of 1913. The Board of Tax Appeals disposed of this contention by a reference to *Thompson Oil & Gas Co.* v. *Commissioner*, 15 B. T. A. 993, and of course this question is no longer open since the decision of this Court in *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301.

amended Regulation invalid and inferentially held the original Regulation invalid also. (R. 240–247.) The Board entered a decision that there were no deficiencies (R. 253). The Circuit Court of Appeals held the amended Regulation valid and reversed the Board, but it declined to remand the case to permit petitioner to bring itself within the amended Regulation by further proof, and therefore affirmed the determination of the Commissioner. (R. 268–295.) A petition for rehearing was denied. (R. 297.)

SUMMARY OF ARGUMENT

The Revenue Act of 1918 provides that in computing net income there shall be allowed as a deduction in the case of oil wells a reasonable allowance for depletion, according to the peculiar conditions of each case, under Regulations of the Treasury Department. The Treasury Regulations provide that where a lessor of oil properties receives a bonus in addition to royalties, the bonus shall be returned as gross income and a depletion allowance made against it in specified proportion. The sole question in this case is one of statutory construction; that is, whether the Commissioner is restricted, in administering this statute, to making depletion deductions only in connection with actual extraction, or whether he may, because of the peculiar nature of a bonus payment made without respect to extraction, make a depletion deduction against it as provided in the Regulations.

The broad language of the Revenue Act of 1918 does not support the view that Congress intended that the depletion allowance should always be required to keep step with actual extraction. Indeed, in giving the Commissioner a large discretion in dealing with depletion it indicated the contrary. This conclusion is strengthened by the fact that the depletion provisions have been reenacted without change five times during a thirteen-year period in which the Regulations have consistently provided that a depletion deduction may be allowed in advance of extraction. Because of the peculiar wasting nature of mineral assets, Congress has permitted taxpayers to take depletion deductions to compensate them for the consumption of their capital. Ordinarily the deduction keeps step with extraction and is applied against the very income produced by the extraction. This results from the fact that the income is received and the extraction takes place simultaneously. In the case of a bonus, however, the income is received before actual extraction. The essential element to be considered in dealing with the bonus is that it is just as much a payment for the oil to be extracted as the royalty is for oil that is extracted. The bonus is in effect an advance royalty, and hence a depletion deduction should be allowed against it in the year when received. Only in this way can the fundamental purpose of the Revenue Acts to tax true annual net income be effectuated. The rule adopted by the Board, that no depletion deductions can be allowed

against a bonus, results in distortion of the annual net income. The opportunistic nature of petitioner's argument in support of the Board's view is shown by the facts that that is the least favorable rule to taxpayers in general, and is in all probability urged here only because petitioner paid no income or excess-profits taxes on the bonuses when it received them and the assessment of such taxes is now barred.

The Circuit Court of Appeals did not abuse its discretion in refusing to remand the case to the Board of Tax Appeals under the circumstances of this case.

ARGUMENT

I

THE AMENDED REGULATION IS VALID

It is no longer open to question that neither an operating owner nor a lessor nor a lessee is entitled as a matter of right to make any deduction from gross income on account of the extraction of the oil which produces the income. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 114; *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 304.

In the Corporation Excise Tax Act of 1909 (c. 6, 36 Stat. 11, 112, Sec. 38) Congress failed to make provision for any deduction on account of the depletion of mineral reserves. Because of the peculiar character of mineral properties and the hardship resulting from the omission of a depletion allowance, Congress provided for some deduction

in the later Revenue Acts. *United States* v. *Ludey*, 274 U. S. 295, 303. In the Income Tax section of the Tariff Act of October 3, 1913 (c. 16, Sec. II, 38 Stat. 114, 166–167) an allowance was made, but it was attacked on the ground that it was wholly inadequate. This Court sustained the right of Congress to put an arbitrary limit on the allowance. *Stanton* v. *Baltic Mining Co., supra.*

In the case of oil and gas wells, the Revenue Act of 1916 (c. 463, 39 Stat. 756, 767) provided for "a reasonable allowance for actual reduction in flow and production." Section 12 (a) Second.

The Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1077) provided in the case of oil and gas wells that there may be deducted from gross income "a reasonable allowance for depletion * * * according to the peculiar conditions in each case." Section 234 (a) (9).

The Commissioner immediately exercised the broad discretion thus given him. By Article 215 of Regulations 45 (*infra*, p. 28, issued April 17, 1919) it was provided that where a lease of mining property required the lessee to pay annual minimum royalties, which would entitle him to actual extraction of the number of units paid for, a depletion deduction should be allowed to the lessor to the extent of the value in the ground of the number of units paid for by the minimum royalty. This was a clear recognition of the power conferred upon the Commissioner to allow depletion in accordance with the basic purpose of the Revenue Acts—to tax

true annual net income—rather than to apply rigidly, and without regard to the varying arrangements which might be made for payments on mineral leases, the principle that the depletion allowance must keep step with actual extraction.

In the 1920 edition of Regulations 45 (issued January 28, 1921) Article 215 was amplified. (See *infra*, p. 29.) The original Article became 215 (b), and Article 215 (a) was added, providing that a bonus paid to a lessor in addition to royalties should be regarded as a return of capital, but only to the extent of the capital remaining to be recovered through depletion by the lessor. These provisions were retained intact in Article 215 (a) and (b) of Regulations 62 under the Revenue Act of 1921, Article 216 (a) and (b) of Regulations 65 under the Revenue Act of 1924, and Article 216 (a) and (b) of Regulations 69 under the Revenue Act of 1926. On November 13, 1926, Article 215 (a) of Regulations 45 and 62, and 216 (a) of Regulations 65, were amended by T. D. 3938 to provide that when a lessor of oil property received a bonus in addition to royalties, a depletion deduction should be allowed with respect to the bonus to the extent of that proportion of the basic value which the bonus bore to the sum of the bonus and the expected royalties. This provision was continued in Article 236 (a) of Regulations 74 under the Revenue Act of 1928, and the minimum royalty provision in Article 236 (b) of the same Regulations. Meanwhile, the provision for depletion as it

appeared in the Revenue Act of 1918 was continued without substantial change in the Revenue Acts of 1921, 1924, 1926, 1928, and 1932.

The sole question in the present case is one of statutory construction. No constitutional question is involved. Compare *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 304. This follows from the cases cited *supra* to the effect that there is no constitutional right to a deduction for depletion in the case of wasting assets. The question of construction presented is whether the provision for depletion, despite the general language used and the specific grant of a discretionary power to the Commissioner to make Regulations, implicitly imposes a requirement that the depletion deduction be coincident with actual extraction. The history of the depletion provisions given above carries conviction that Congress did not intend that there should be any such restriction, since the reenactments of the depletion clause without change during a thirteen-year period in which the Treasury Regulations had consistently provided that a depletion allowance should be made without regard to actual extraction within the year must be taken to have approved an interpretation of the depletion allowance which did not require it to keep step with actual extraction. See *National Lead Co.* v. *United States*, 252 U. S. 140, 146–147; *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, 235; *Brewster* v. *Gage*, 280 U. S. 327, 337; *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 307–308; *United States* v. *Kirby Lumber Co.*, 284

U. S. 1. This conclusion is fatal to petitioner's argument that the inherent nature of the depletion deduction is such that it must be coincident with actual extraction.

Our position is that the Commissioner was justified in allowing a depletion deduction against a bonus received by a lessor of oil property, since only in that way could he give effect to the fundamental intent of the Revenue Acts to tax true annual net income. It is true that where no cash bonus is involved the depletion allowance is made in step with the exhaustion of the resources; but it is also true that in such cases the deduction is applied against the very income produced by such exhaustion. In contemplation of law the cash bonus bears the same relation to the exhaustion of the resources as the royalty payments. The bonus is royalty paid in advance [5] and it involves no departure from established principles of depletion to require deduction of the depletion allowance from the bonus when received by the lessor. If royalty payments are anticipated by payment of a bonus, there is nothing in the theory of depletion nor in the mandate of the statute which would prevent the allowance of a depletion deduction in advance of actual exhaustion. The underlying purpose of the statute requires that it be so administered as to reflect with accuracy the annual income

[5] See *Burnet* v. *Harmel*, decided November 7, 1932, No. 26, October Term, 1932.

upon which the tax is laid, and it is important that the true annual net income should be taxed and to this end that the depletion allowance should be applied to all of the income as and when received. This can only be accomplished as the amended Regulation requires by applying the deduction for depletion to bonus payments and royalty payments alike. In cases involving a bonus—an advance royalty—the receipt of the royalty in advance requires the allowance of the depletion deduction in advance of the extraction, to the end that true income may be reflected. Since the lessor has granted the right to take oil and has been paid in advance, he has in effect been paid for the depletion which will occur upon extraction by the lessee and it is from such payment that depletion must be deducted if net income is to be correctly determined.

The depletion deduction is allowed to a taxpayer to compensate him for the partial exhaustion of his mineral reserves. The theory is that since the gross income from the operation of mineral properties represents a return not only from the *use* of capital but from its partial *exhaustion,* a deduction should be allowed to the extent of the latter in computing the income tax. The nature of the depletion deduction was described by this Court in *United States* v. *Ludey,* 274 U. S. 295, 302, as follows:

> The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any

> year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserve used up is allowed.

Where the owner of the oil well is also the operator, the problem of calculating depletion is easily solved. The basic value of the property is divided by the estimated number of barrels of oil in the ground, and the quotient is the unit of depletion. Each year thereafter the proceeds of the sale of oil are treated as gross income, from which is deducted a sum calculated by multiplying the number of barrels extracted during the year by the unit of depletion. See Article 210 of Treasury Regulations 45, under the Revenue Act of 1918.

The problem is likewise easy of solution where a lessor of oil properties receives only royalties depending upon production. The lessor reports the royalties as income, and a depletion allowance is made in the same year, calculated by multiplying the number of barrels extracted during the year by the lessor's unit of depletion (ascertained as in the case of the operating owner, *supra*). In both these cases the depletion allowances keeps step with ac-

tual exhaustion of the oil reserves, and the depletion deduction is applied against the very income which resulted from the extraction of oil in that year, so that the tax falls only upon the true net income for the year.

The problem is somewhat complicated where, as in the instant case, the lessor receives a bonus in addition to royalties based upon production. The essential fact to be borne in mind in considering the nature of a bonus is that it is an advance or supplemental royalty—in effect, a part of the royalty in a lump sum or down payment. It was so held by this Court in *Work* v. *Mosier,* 261 U. S. 352, 357–358. See also *Burnet* v. *Harmel, supra; Burkett* v. *Commissioner,* 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Berg* v. *Commissioner,* 33 F. (2d) 641 (App. D. C.), certiorari denied, 280 U. S. 598; *Alexander* v. *King,* 46 F. (2d) 235, 239–240 (C. C. A. 10th), certiorari denied, 283 U. S. 845; *Ferguson* v. *Commissioner,* 59 F. (2d) 891 (C. C. A. 10th); *Hirschi* v. *United States,* 67 C. Cls. 637, certiorari denied, 280 U. S. 576; *Appeal of Nelson Land & Oil Co.,* 3 B. T. A. 315, 326; *State ex rel. Inter-State Iron Co.* v. *Armson,* 166 Minn. 230. Cf. *United States* v. *Biwabik Mining Co.,* 247 U. S. 116, 121.

This view is sound, because bonus and royalties alike are the consideration derived by the lessor from the use of property which is wasted in use. The fact that the oil reserve has not been extracted

when the bonus is paid is unimportant. The important consideration is that the lessor has been paid an advance royalty and to that extent has been paid for the exhaustion even though it has not yet occurred. Depletion must be applied to income derived from the use of the property which consumes it, and in so far as the lessor is concerned, that income comprises bonus as well as royalty.

Our contention that a bonus is advance royalty is also supported by decisions in cases where lessee taxpayers sought to deduct the entire bonus as a business expense in the year in which paid. It has uniformly been held in such cases by the Bureau of Internal Revenue,[6] by the Board of Tax Appeals,[7] and by the courts [8] that such a bonus is ad-

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[6] Article 109, Treasury Regulations 45 and 62; Article 110, Treasury Regulations 65 and 69; Article 130, Treasury Regulations 74; I. T. 1711, II–2 C. B. 104; A. R. R. 6459, III–1 C. B. 138.

[7] *Nelson Land & Oil Co.*, 3 B. T. A. 315, 325–326; *Burkett* v. *Commissioner*, 7 B. T. A. 560, affirmed, 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Hazlett* v. *Commissioner*, 10 B. T. A. 332, 337; *Parkey* v. *Commissioner*, 16 B. T. A. 441, 445; *Baton Coal Co.* v. *Commissioner*, 19 B. T. A. 169, affirmed, 51 F. (2d) 469 (C. C. A. 3d), certiorari denied, 284 U. S. 674; *Ferguson* v. *Commissioner*, 20 B. T. A. 130, 131, reversed, 45 F. (2d) 573 (C. C. A. 5th); Klein, Federal Income Taxation, p. 439. Cf. *Waggoner* v. *Commissioner*, 24 B. T. A. 657.

[8] *Central Nat. Bank* v. *United States*, 283 Fed. 368, 373 (C. C. A. 8th), dismissed, 264 U. S. 600; *Alland & Bro.* v. *United States*, 28 F. (2d) 792 (Mass.); *Hirschi* v. *United States*, 67 C. Cls. 637; *Burkett* v. *Commissioner*, *supra*; *Baton Coal Co.* v. *Commissioner*, *supra*; *Galatoire Bros.* v.

vance rental or royalty, and that the deduction must be taken over the life of the lease.

We submit that unless the bonus is treated as an advance royalty and a depletion allowance made against it the underlying purpose of the Revenue Acts will be defeated. This Court has repeatedly pointed out that that purpose is to tax true annual net income. *United States* v. *Anderson,* 269 U. S. 422; *United States* v. *Mitchell,* 271 U. S. 9; *Aluminum Castings Co.* v. *Routzahn,* 282 U. S. 92; *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359; *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301; *Woolford Realty Co.* v. *Rose,* 286 U. S. 319. The purpose can not be effectuated with respect to bonus payments unless they are treated as advance royalties and an allowance made against them for depletion.

If the depletion allowance must always await actual extraction, as contended by petitioner, it will not, in the case of a bonus, be used as an offset against that part of the income which is represented by the bonus. In the present case, for example, the bonuses were paid between 1913 and 1918. Extraction took place not only in those years but also in 1919 and 1920 (the taxable years now in question) and presumably for a number of years thereafter. (There was a reserve of about 3,400,00 barrels of oil in the Coyote property at the end of 1920.)

Lines, 23 F. (2d) 676 (C. C. A. 5th). See *Constantine* v. *Wake*, 1 Sweeny (N. Y.) 239, 244; *Crile* v. *Commissioner*, 55 F. (2d) 804 (C. C. A. 6th). Cf. *Jennings & Co.* v. *Commissioner*, 59 F. (2d) 32 (C. C. A. 9th).

(R. 251.) The true return to petitioner in any year was not the amount of the royalties for that year but the sum of the royalties plus the portion of the bonuses allocable to the extraction of that year.

If we apply petitioner's theory that no depletion deduction may be made with respect to the bonuses, the result will be a distortion in petitioner's income. Against the income received by petitioner in 1919 and 1920, which is only a portion of the income attributable to the oil extracted in those years, will be allowed a depletion deduction for its entire interest in the quantity of oil then extracted. Hence petitioner's calculation of its net income for those years does not reflect its true income, the calculation being less than the true net income to the extent of the portion of the bonuses allocable to those years. On the other hand, petitioner's net income for the years when the bonuses were paid would be distorted in the opposite direction by treating the bonuses as petitioner urges, since in such case no depletion deduction would be allowed against them, despite the fact that the bonuses represented a payment for oil to be extracted. This would result in petitioner's calculated net income for those years being higher than the true net income.

These considerations reveal how completely opportunistic is petitioner's argument in the present case. If the instant case had arisen in 1918 petitioner would scarcely have contended that no deple-

tion deduction could be taken against the bonus paid in that year, since upon that theory it would then have had to pay income and excess-profits taxes for the year out of all proportion to the true annual net income.

The position taken by petitioner that no depletion allowance may be made with respect to a bonus is less favorable to taxpayers in general than either the original or amended Regulation.[9] Even after the excess-profits tax was repealed, refusal to permit a depletion allowance against a bonus would, in the case of individual taxpayers (although not in that of corporations) result in a disproportionate tax for the year in which the bonus was received by bringing the total sum up into the higher brackets. Moreover, under the rule urged by petitioner the taxpayer's annual depletion deductions based upon actual extraction might not return to him the entire value of his mineral reserves as of the basic date. If they did not, the taxpayer would be in the position of having paid taxes upon a sum greater than the total net income derived by him from his oil well. Petitioner's advocacy of a rule which would produce these incongruous results must be based upon the fact that it escaped taxation upon the bonus payments when received and that assessment of taxes with respect to them is now barred by the statute of limitations.

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[9] See Appendix B.

The original Regulation, which treated the bonus as a return of capital, was the most favorable rule possible for taxpayers, since under that Regulation no income or excess-profits tax would be paid upon the bonus. Instead of paying a high excess-profits tax upon the bonus, or in the case of an individual the high income tax of the upper brackets, the taxpayer would, in each year of extraction, pay taxes at a lower rate, based, in effect, upon the sum of the royalties received in, and the portion of the bonus allocable to, that year. This would result from the decrease in the unit of depletion worked by deducting the total amount of the bonuses from the capital sum returnable through depletion. The result of thus decreasing the unit of depletion would be the same in any given year as that of increasing the income by a proportionate share of the bonus.

While the validity of the original Regulation is immaterial if the Court accepts our contention that the amended Regulation is valid, it should perhaps be pointed out that there is no inconsistency in holding that the total amount of the bonus must be reported as gross income, and in holding that bonus is to be regarded as a return of capital for purposes of computing depletion. The purpose of the depletion allowance, consistently expressed in the Treasury Regulations,[10] is that the taxpayer may recoup free of tax the value of the mineral re-

[10] Reg. 33, Art. 142; Reg. 45, Art 201; Reg. 62, Art 201; Reg. 69, Art. 201; Reg. 74, Art 221.

serves as of the basic date. This sufficiently shows that the depletion deduction is regarded as a return of capital. Thus the original Regulation meant merely that depletion to the extent of the entire bonus should be taken as a deduction from the bonus. This was a convenient rule of thumb to apply to a necessarily complicated situation, and, as already indicated, operated most favorably to taxpayers. The fact that Congress reenacted the depletion provisions without change three times (in the Acts of 1921, 1924, and 1926) while the original Regulation was in force is strong evidence that Congress approved of such an interpretation of the statute. See cases cited *supra,* p. 12.

However, the original Regulation was amended not long after the Board's decision in *Appeal of Nelson Land & Oil Co., supra,* by T. D. 3938 (*infra,* p. 31). It is difficult to see how the amended Regulation can be objectionable. It does not distort the amount of taxable income either in the years of receipt of the bonuses or subsequently. It strictly enforces the fundamental intent of Congress to tax true annual net income. It provides a variable but logical and workable rule which fits each case by making the amount of the depletion deduction turn upon the relationship between the bonus and the sum of the bonus and expected royalties. Indeed, the Board itself recognized that the amended Regulation might operate more equitably than the rule which it adopted. (R. 246.)

In holding that it is contrary to the depletion concept to make a depletion allowance except with reference to actual extraction, the Board disregarded the fact that the depletion provisions had been reenacted without change five times despite the existence of Regulations providing for depletion deductions in years other than that of actual extraction (see *supra, pp.* 11–12), and twice since the promulgation of the amended Regulation. We submit, as the court below held (R. 290), that the amended Regulation not only does not conflict with the statute but clearly conforms to it.

Petitioner urges that the decisions of this Court in *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301, and *Lynch* v. *Alworth-Stephens Co.,* 267 U. S. 364, are decisive in its favor. It is true that the language used by this Court in those cases supports the view that depletion keeps step with actual extraction. That is generally true. (*Supra,* p. 13.) Our position is that because of the peculiar nature of bonuses a depletion deduction must be made against them when received, even though in advance of extraction, since only by that method may the true annual net income be determined. The question of the treatment of bonuses was not presented in either of the two cases cited, and the Court, in using the language referred to, probably had in mind current royalties only.

II

THE CIRCUIT COURT OF APPEALS DID NOT ABUSE ITS DISCRETION IN DECLINING TO REMAND THE CASE FOR FURTHER HEARING

At the hearing before the Board of Tax Appeals the petitioner failed to prove the amount of the royalties expected to be received under the lease. This is one of the essential elements in the computation of the depletion allowance under the amended Regulation (*infra,* p. 31). That Regulation was promulgated as T. D. 3938 on November 13, 1926 (V–2 C. B. 117), and had been in effect nearly two years when the depletion question here involved was first raised by the petitioner in its second amended petition to the Board of Tax Appeals on September 21, 1928. (R. 38.)

The hearing before the Board took place on October 22, 1928, and the Government filed its brief pointing out the Commissioner's error in failing to apply the amended Regulation on January 5, 1929. Petitioner filed its brief on January 21. Although the Board did not decide the case until more than two months later (March 30; see R. 3), petitioner made no application in the interim for an opportunity to bring itself within the amended Regulation.

Petitioner went before the Board upon the theory that no deduction for depletion was per-

missible with respect to the bonuses in the year of their receipt. It ignored the amended Regulation and failed to show the amount of royalties expected to be received under the lease, an essential factor in the application of the Regulation. In these circumstances the Circuit Court of Appeals held that the computation made by the Commissioner under the original Regulation must stand. (R. 291.)

Since the Circuit Court of Appeals reversed the decision of the Board, it had power, under Section 1003 (b) of the Revenue Act of 1926 (*infra*, p. 28), to remand the case for rehearing. But we submit that it was not required to do so, and that under the circumstances there was no abuse of discretion. In order that the burden of proof rule may be given its proper effect and that litigation may come to an end, the taxpayer should be required to prove its case in the first instance, at least where, as here, it has had the opportunity of doing so. Cf. *Toledo Scale Co.* v. *Computing Scale Co.*, 261 U. S. 399, 424–425.

CONCLUSION

The judgment of the Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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NOVEMBER, 1932.

APPENDIX A

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077:

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this par-

agraph shall be equitably apportioned between the lessor and lessee;

* * * * *

Revenue Act of 1926, c. 27, 44 Stat. 9, 109, 110:

SEC. 1001. (a) The decision of the Board rendered after the enactment of this Act (except as provided in subdivision (j) of section 283 and in subdivision (h) of section 318) may be reviewed by a Circuit Court of Appeals, or the Court of Appeals of the District of Columbia, as hereinafter provided, if a petition for such review is filed by either the Commissioner or the taxpayer within six months after the decision is rendered.

* * * * *

(U. S. C. Sup. V, Title 26, Sec. 1224.)

SEC. 1003. (b) Upon such review, such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board, with or without remanding the case for a rehearing, as justice may require. (U. S. C. Sup. V, Title 26, Sec. 1226.)

Article 215 of Treasury Regulations 45 under the Revenue Act of 1918 (unrevised; promulgated April 17, 1919) provided as follows:

ART. 215. *Depletion of mine based on advance royalties.*—Where the owner has leased a mining property for a term of years with a requirement in the lease that the lessee shall mine and pay for annually a specified number of tons or other agreed units of measurement of such mineral, or shall pay annually a specified sum of money which shall be applied in payment of the purchase price or agreed royalty per unit of such mineral whenever the same shall thereafter be mined and removed from the

leased premises, the value in the ground to the lessor for purposes of depletion of the number of units so paid for in advance of mining will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the mining or removal in such year of any ore or mineral so paid for in advance and for which deduction has been once made. If for any reason any such mining lease shall be terminated before the ore or mineral therein which has been paid for in advance has been mined and removed, and the lessor repossesses the leased property, an amount equal to the aggregate deductions for depletion allowed in respect of ore or mineral not mined and removed by the lessee, but still in the ground, will be deemed income to the lessor and will be returned as such for the year in which the property is repossessed.

Treasury Department Regulations 45 (1920 Edition):

ART. 215. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(*a*) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through deple-

tion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

(*b*) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is ter-

minated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from capital recoverable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned.

Article 215 of Regulations 62 and Article 216 of Regulations 65 are substantially the same as Article 215 above quoted.

T. D. 3938, V–2 C. B. 117:

Article 215 of Regulations 45 (1920 edition), article 215 of Regulations 62, and article 216 of Regulations 65 are hereby amended to read as follows:

ART. 216 (215). *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a

requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be re-

quired to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

All rulings inconsistent herewith are hereby revoked.

Approved November 13, 1926.

This Treasury Decision appears as Article 216 of Regulations 69 and Article 236 of Regulations 74.

APPENDIX B

The results of various methods of treating a bonus may be demonstrated as follows:

Assume the following facts:

A owned a developed oil property in fee at March 1, 1913. The fair market value of the oil and gas rights at March 1, 1913, was $3,000,000. The estimated oil reserves at March 1, 1913, were 6,000,000 barrels. From March 1, 1913, to Dec. 31, 1917, 2,000,000 barrels of oil were produced and sold from the property. Consequently the capital sum remaining to be recovered through depletion at January 1, 1918, was $2,000,000, and the remaining recoverable oil reserves were 4,000,000 barrels. In the following examples these amounts are referred to as the "Capital Sum" and the "Reserves," respectively.

On January 1, 1918, A leased the property to B. The lease provided for the customary lessor's royalty of one-eighth, and B paid A a bonus of $600,000. In the light of market conditions at the date of the lease the royalties expected under the lease were $1,000,000. 800,000 barrels of oil were produced and sold from the property during 1918.

Apply the above facts in each of the following cases:

Case I. If Article 215, Regulations 45, before amendment, is the correct statement of the law.— That is, regard the bonus as a nontaxable return of capital to the full extent that there is capital to be returned through depletion. Reduce the capital sum by the amount of the bonus and permit the

remainder of the capital sum to be returned through ordinary depletion deductions as the ordinary royalties are received, concurrent with the production and sale of the oil.

Case II. If Treasury Decision 3938, amending Article 215, Regulations 45, is the correct statement of the law.—That is, treat the bonus and ordinary royalties as income but allow a depletion deduction because of the bonus in an amount equal to that portion of the capital sum which is represented by the ratio of the bonus to the sum of the bonus and the royalties expected under the lease. After making this depletion allowance permit the remainder of the capital sum to be returned through ordinary depletion deductions as the ordinary royalties are received, concurrent with the production and sale of the oil.

Case III. If the decision of the Board of Tax Appeals in the Murphy Oil Company case is the correct statement of the law.—That is, treat the bonus and ordinary royalties as income; allow no depletion deduction because of the bonus, but permit the entire capital sum to be returned through ordinary depletion deductions as the ordinary royalties are received, concurrent with the production and sale of the oil.

The results of computation under the three cases appear in the following tabulation:

	Case I (original regulation)	Case II (amended regulation)	Case III (B. T. A. decision)
(a) Capital sum, Jan. 1, 1918	$2,000,000	$2,000,000	$2,000,000
(b) Reserves, Jan. 1, 1918 ..... barrels	4,000,000	4,000,000	4,000,000
(c) Bonus	$600,000	$600,000	$600,000
(d) Royalties expected under the lease	$1,000,000	$1,000,000	$1,000,000
(e) Gross production, 1918 ..... barrels	800,000	800,000	800,000
(f) Lessor's one-eighth, 1918 ..... do	100,000	100,000	100,000
(g) Deduction allowable in 1918 because of the bonus	$600,000	$750,000	None.
(h) Capital remaining to be returned through depletion concurrent with ordinary royalties	$1,400,000	$1,250,000	$2,000,000
(i) Deduction allowable in 1918 as depletion with respect to ordinary royalties	$280,000	$250,000	$400,000
(j) Total allowable deductions for depletion or return of capital in 1918	$880,000	$1,000,000	$400,000
(k) Capital remaining to be recovered through depletion after 1918	$1,120,000	$1,000,000	$1,600,000
(l) Total ultimate allowable deductions for return of capital, 1918 and later	$2,000,000	$2,000,000	$2,000,000

NOTE.—(1) Item (g) in Case II is determined as follows:

$$\text{Bonus depletion} = \frac{\text{Bonus (600,000)}}{\text{Bonus (600,000), plus expected royalties (1,000,000)}} \times \frac{}{\text{Capital sum (2,000,000)}} = \$750{,}000.$$

NOTE.—(2) Item (i) in each case is one-fifth of item (h), because the production in 1918 used up one-fifth of the oil reserves remaining at the beginning of 1918.

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APPENDIX C

TREASURY DEPARTMENT,
BUREAU OF INTERNAL REVENUE,
Washington, October 29, 1932.

Hon. G. A. YOUNGQUIST,
Assistant Attorney General,
Washington, D. C.

In re Murphy Oil Company, Whittier, Calif., B. T. A. No. 14440, C. C. A. Nos. 6388–6459, C. C. A. 9th Circuit. Sup. Ct. No. 955.

SIR: In accordance with the request of your office that you be advised in connection with the way in which the Murphy Oil Company treated the $5,500,000.00 received by it from the Standard Oil Company of California as a bonus for a lease entered into in December, 1913, you are advised as follows:

On the original return for 1913, the Murphy Oil Company reported income from the bonus in the amount of $1,108,600.97 and paid a tax on the total net income reported for such year of $14,816.54. The Acting Commissioner, G. E. Fletcher, on November 13, 1915, increased the net income of the Murphy Oil Company for 1913 by $1,446,637.19 and caused additional assessment of $14,476.37 to be made. This additional assessment was also paid. On January 7, 1920, the Murphy Oil Company filed an amended income-tax return for the year 1913, reporting income from the bonus received from the Standard Oil Company in the

amount of $5,108,600.97, which indicated a total tax liability of $54,531.11, or an additional tax above that previously paid of $25,238.20. This additional tax apparently was assessed in 1920, but was never paid. The Murphy Oil Company for the years 1914 to 1918, inclusive, did not report any of the bonus received during such years as income either upon its original returns or upon its amended returns for such years.

The Bureau, when it audited the returns for the years 1913 to 1918, inclusive, for which years overassessments were scheduled on February 21, 1924, excluded all of the $5,500,000.00 received from the Standard Oil Company from gross and net income for the year 1913 and added no portion of it to income for any other year. As a result of such Bureau audit, it was found that by eliminating all of the bonus, the Murphy Oil Company's tax liability for the year 1913 was $3,456.51. The remainder of the $54,531.11 which had been previously assessed, was abated to the extent of $25,238.20 and refunded to the extent of $2,740.26, or a total of $27,978.46 was either refunded or abated. The remainder of the overassessment, or $23,096.14, was not refunded because the statute of limitations had run against the making of such a refund.

Therefore, an examination of the file clearly shows that no tax was ever assessed or paid with respect to the bonus received from the Standard Oil Company except for the year 1913 and of all the tax assessed or paid for such year with respect to such bonus, all except $23,096.14 was refunded.

Respectfully,

C. M. CHAREST,
General Counsel.

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